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Legend

Insurance Company 1 =

State 1 =

Jurisdictions =

Insurance Company 2 =

State 2 =

Parent =

Charge A =

Charge B =

Date C =

Benefit =

Rider Benefit =

Rider =

Rider Conditions =

D Percentage =

Annual Rider Benefit =

E Limit =

F Policy Year =

Insured's Age G =

H Policy Years =

J =

K =

L =

M =

N =

P =

Q =

R =

S =

T =

Dear :

Taxpayers have requested rulings regarding the application of § 7702 of the Internal Revenue Code (Code) with respect to the Rider Benefit Taxpayers intend to offer.

FACTS

Insurance Company 1 is a stock life insurance company incorporated under State 1 law. Insurance Company 1 is licensed to engage in the life insurance business in Jurisdictions. Insurance Company 1 is a life insurance company within the meaning of § 816(a).

Insurance Company 2 is a stock life insurance company organized and operated under State 2 law. Insurance Company 2 is licensed to engage in the life insurance business in State 2. Insurance Company 2 is a life insurance company within the meaning of § 816(a).

Insurance Company 1 and Insurance Company 2 (together the “Taxpayers”) join in the filing of a consolidated federal income tax return with Parent and other eligible affiliates on an accrual accounting, calendar year basis.

Taxpayers intend to market certain flexible premium variable universal life insurance contracts (the “Policies”). Taxpayers represent the Policies are life insurance contracts under the laws of the states and other jurisdictions in which they will be issued. The Policies have flexible premiums, subject to certain requirements (e.g., compliance with § 7702). The Taxpayers intend to offer a rider (the “Rider”) with the Policies; the Rider is designed to make available to policyholders a minimum annual withdrawal or loan amount, irrespective of the investment performance of the Policy.

The Policies will have a cash value (the “policy value”). The Taxpayers represent that apart from the effect of the Rider (as described below), at all times the policy value is the “cash surrender value,” within the meaning of § 7702(f)(2)(A), of the Policy. The policy value is increased by premiums paid and by interest and other investment earnings. The policyholder can pay premiums at any time, subject to certain constraints stated in the Policy. Premiums (net of a premium charge, the maximum amount of which is set forth in the policy specifications pages) are allocated to subaccounts, generally as directed by the policyholder. In addition, each month a deduction is made from the policy value for certain expense charges under the Policy, including Charge A, Charge B (if applicable), an administrative charge, the charges for any riders attached to the Policy, and a deduction for cost of insurance which is based on the 2001

Commissioners' Standard Ordinary (CSO) mortality tables. The maximum charge for each of these items is set forth in the Policy, but the Taxpayers in their discretion may charge less.

A policyholder may choose to receive a loan under the Policy. The portion of the policy value that constitutes the collateral in respect of policy debt (*i.e.*, outstanding policy loans and unpaid interest thereon) is allocated to the Loan Account. In general, if the sum of policy debt exceeds the policy value, the Policy will be in default and will terminate at the end of a grace period.

The Policies may be surrendered for their net cash surrender value (NCSV). In this regard, the NCSV equals the Cash Surrender Value less the policy debt and the Cash Surrender Value of a Policy equals the policy value less any applicable Surrender Charge. The Policy also allows withdrawals of a portion of the NCSV. Such withdrawals also reduce the policy value and may reduce the Death Benefit (defined below). Unless a no lapse guarantee applies (as discussed below in connection with the Death Benefit), the Policy terminates when the NCSV equals zero.

If the insured under a Policy (the "Insured") dies while the Policy is in force, the Taxpayers pay the Benefit upon receipt of due proof of death of the Insured. Subject to a minimum death benefit section (discussed below), the Benefit equals (a) the Death Benefit, plus (b) any death benefit payable under any supplementary benefit riders that forms part of the Policy, less (c) any outstanding policy debt at the date of death.

The Policies provide that the sum of the Death Benefit and any death benefit payable under any supplementary benefit rider will never be less than the minimum death benefit. In general, the minimum death benefit is equal to the minimum death benefit factor for the age of the Insured multiplied by the policy value on the date of death of the Insured. Minimum death benefit factors are set forth in the policy specifications pages and differ depending on whether the Policy is intended to satisfy the Cash Value Accumulation Test (CVAT) of § 7702(b) or the Guideline Premium Limitation (GPL) and Cash Value Corridor Test (CVC Test) of § 7702(c) and (d).

Both the base Policy form and the Rider include certain "no lapse" guarantees. Under these provisions, if certain requirements are satisfied, the Taxpayers guarantee that a Policy will not lapse, even if the Policy otherwise would lapse due to insufficient NCSV. Where the no lapse guarantee is operating to keep a Policy in force, the Taxpayers remain liable for payment of the Benefit upon the death of the Insured.

At the time a Policy is purchased, a policyholder can choose to include the Rider as part of his or her Policy. The Rider offers certain benefits:

First, if the policyholder follows the Rider Conditions (*i.e.*, pays premiums in a prescribed manner, takes no withdrawals or loans prior to Date C, maintains a Face Amount and death benefit option in a prescribed manner, and meets certain other criteria), under the Rider, the policyholder is entitled to the Rider Benefit. Taxpayers represent that the Rider and Rider Benefit are part of the Policies for state law purposes and are not regulated or otherwise treated under state law as an annuity contract or as some other type of non-life insurance contract. As discussed in more detail below, the Rider Benefit guarantees that certain distributions can be made from the Policy after Date A for a specified period of years, even though in the absence of the Rider Benefit there might not be sufficient NCSV to make such distributions.

Second, if the policyholder follows the Rider Conditions, the Rider guarantees that the Policy will not lapse. Thus, if the policy value is dramatically reduced because of losses in the subaccounts which underlie the Policy and, correspondingly, the net amount at risk and cost of insurance charges substantially increase, the Rider guarantees that the Policy will not lapse, even if there is insufficient NCSV to fund cost of insurance and other expense charges under the Policy. Under this “no lapse” guarantee, the Benefit remains payable upon the death of the Insured.

The Rider is funded by a monthly charge that is assessed against the policy value. This charge equals the product of the policy value on the monthly processing date and the D Percentage shown on the policy specifications pages. If there is insufficient NCSV to pay this charge and a no lapse guarantee is in effect, this charge is waived.

Under the Rider Benefit, annual payments up to the Annual Rider Benefit are available upon request by the policyholder beginning on Date A and continue to be available each year during the Rider Benefit Period, even though in the absence of the Rider Benefit there may be insufficient NCSV in the Policy to make the distributions.

The key features of the Rider Benefit are as follows:

- *The Annual Rider Benefit.* The Annual Rider Benefit is specified in a Policy at issue, but may change after the date of issue if the policyholder does not follow the Rider Conditions or if he or she modifies the scheduled length of the Benefit Period prior to Date A. The Annual Rider Benefit is the maximum amount that is available for distributions each Policy Year during the Rider Benefit Period (the period beginning with Date A and ending when the sum of distributions equals or exceeds the E Limit). The Annual Rider Benefit is determined based on a number of factors, *e.g.*, the planned premium payments, the Death Benefit under the Rider Conditions, Date A, the Benefit Period, and the age, risk class, and sex of the Insured.

- *The Benefit Period.* The Benefit Period and Date A are both specified in the Policy at issue and will only be modified if there is a change in the Rider Conditions (as discussed below). The Benefit Period begins on Date A, which is the date on which the policyholder becomes entitled to distributions under the Rider Benefit if the Rider is in force on such date. The Benefit Period can begin no earlier than the later of the F Policy Year and the Insured's Age G, and must be a period of at least H Policy Years. A policyholder generally may request a longer Benefit Period (subject to the approval of the Taxpayers) anytime prior to Date A, although doing so will make the Annual Rider Benefit smaller.
- *Maximum amount that can be paid under the Rider Benefit.* The total amount of distributions that can be paid pursuant to the Rider Benefit equals the E Limit , which equals the product of the Annual Rider Benefit and the scheduled number of years for the Benefit Period as indicated on the policy specifications pages (or as modified prior to Date A).
- *Effect of receiving distributions that are smaller than the Annual Rider Benefit.* A policyholder may choose to take distributions in a Policy Year after Date A in an amount that is smaller than the Annual Rider Benefit. Since the Rider Benefit generally remains in effect until distributions equal the E Limit, receiving distributions in an amount that is smaller than the Annual Rider Benefit has the effect of lengthening the period over which distributions under the Rider Benefit may be received.
- *Form of distributions.* "Distributions" for purposes of the Rider Benefit include both of the following on and after Date A: (1) withdrawals of any portion of the Policy's NCSV, as described in the surrender and withdrawals of the Policy, and (2) loans against the Policy's NCSV, as described in the loan section of the Policy.
- *Mechanics of payment.* If a policyholder is entitled to the Rider Benefit and the NCSV is insufficient to make a distribution of the Annual Rider Benefit, the policy value is increased by the excess of (a) the amount of the distribution requested (but not by more than the Annual Rider Benefit) over (b) the NCSV.

If there is a deviation from the Rider Conditions, the Rider Benefit is generally recalculated. If deviation from the Rider Conditions would cause the recalculated Annual Rider Benefit to be reduced to zero, the Rider will terminate.

Various other events, as specified in the Rider, also will result in the termination of the Rider. For example, if distributions in any Policy Year on and after Date A exceed the Annual Rider Benefit, the Rider terminates. Also, once total distributions on and after Date A exceed the E Limit, the Rider terminates.

Absent the Rider, the Policy's minimum death benefit equals the product of (1) the applicable minimum death benefit factor (the amount of which depends on the age of the Insured and whether the Policy is intended to meet the CVAT or the CVC Test), and (2) the policy value. The Taxpayers have structured the Rider to provide that, during the Rider Benefit Period (*i.e.*, beginning on Date A and continuing until the sum of the distributions equals or exceeds the E limit), the minimum death benefit is calculated by multiplying (1) the applicable minimum death benefit factor by (2) the greater of (a) the policy value at such time, and (b) the Annual Rider Benefit.

Taxpayers attached to their submission Exhibit C as an illustration of the operation of the Rider Benefit provided by the Rider under a Policy. The Policy covers a female, non-smoker Insured who is age M at the time of issuance of the Policy, and the illustration generally reflects growth of the policy value based on J% market returns and current mortality and expense charges. In the R Policy Year (just before Date A), however, it is assumed that there is a very substantial market decline which reduces the policy value by K%. The illustration assumes that the Annual Rider Benefit specified at issue is L, and the Rider Conditions contemplates (a) a Q Face Amount, (b) an option 1 level death benefit pattern at all times, (c) payments of premiums of \$P per year for the first seven Policy Years, and (d) no withdrawals or loans prior to Date A. The Rider Conditions are followed in the illustration, and thus the Rider Benefit provides that distributions up to the Annual Rider Benefit of \$L may be received in each Policy Year beginning with Date A (*i.e.*, the beginning of Policy Year S, when the insured is age T) and continuing for a period of M years (*i.e.*, ending when the insured is age N).

REQUESTED RULINGS

Taxpayers request the following rulings:

1. The "cash surrender value," for purposes of § 7702(f)(2)(A), of the Policy at any time is its cash value, and a Policy's cash value is the greater of (i) the maximum amount to which the policyholder is entitled upon surrender of the Policy (determined without regard to any surrender charge or policy loan), or (ii) the maximum amount against which the policyholder can borrow under the Policy.
2. Calculations of the net single premium under the cash value accumulation test and of the guideline premium limitation for the Policy are unaffected by the presence of the Rider Benefit.

LAW

Section 7702 defines the term “life insurance contract” for all purposes of the Code, including the death benefit exclusion under § 101(a). To satisfy this definition, a life insurance contract must be a life insurance contract under “applicable law” and must meet one of two tests set forth in § 7702, *i.e.*, the “cash value accumulation test” (CVAT) of § 7702(a)(1) and (b), or the “guideline premium limitation” and “cash value corridor” tests of § 7702(a)(2), (c), and (d) (*i.e.*, the GPL and CVC Test, respectively). In general, § 7702 applies to all life insurance contracts issued after December 31, 1984. The Policies are subject to § 7702, and certain of the Policies are intended to comply with the CVAT while others are intended to comply with the GPL and CVC Test.

A contract meets the CVAT if, by its terms, the contract’s “cash surrender value,” within the meaning of § 7702(f)(2)(A) may not at any time exceed the net single premium (“NSP”) that would have to be paid at such time to fund the future benefits under the contract. See § 7702(b)(1), (f)(2)(A), and (f)(4). The term “future benefits” is defined for purposes of § 7702 to include death benefits, any endowment benefits guaranteed under the contract, and reasonable charges for qualified additional benefits (such as accidental death benefits) that are reasonably expected to be actually paid. Under § 7702(b)(2), the NSP must be computed –

(A) on the basis of interest at the greater of an annual effective rate of 4 percent or the rate or rates guaranteed on issuance of the contract,

(B) on the basis of the rules of [§ 7702(c)(3)(B)(i), relating to reasonable mortality charges] (and, in the case of qualified additional benefits, [§ 7702(c)(3)(B)(ii), relating to reasonable expense charges]), and

(C) by taking into account under [§ 7702(e)(1)(A) and (D), relating to certain computational rules] only current and future death benefits and qualified additional benefits.

The guideline premium requirements of the GPL are met if, at all times, the sum of the premiums paid under a life insurance contract does not exceed the “guideline premium limitation” at that time. The guideline premium limitation as of any date is defined in § 7702(c)(2) as the greater of the “guideline single premium” or the sum of the “guideline level premiums” as of that date. For contracts entered into on or after October 21, 1988, § 7702(c)(3)(B) provides that the “guideline single premium” shall be based on:

(i) reasonable mortality charges which meet the requirements (if any) prescribed in regulations and which (except as provided in regulations) do not exceed the

mortality charges specified in the prevailing commissioners' standard tables (as defined in § 807(d)(5)) as of the time the contract is issued,

(ii) any reasonable charges (other than mortality charges) which (on the basis of the company's experience, if any, with respect to similar contracts) are reasonably expected to be actually paid, and

(iii) interest at the greater of an annual effective rate of 6 percent or the rate or rates guaranteed on issuance of the contract.

Section 7702(c)(4) provides that the "guideline level premium" is the level annual premium equivalent of the guideline single premium, payable until a deemed maturity date between the insured's attained ages 95 and 100, calculated assuming interest at the greater of an annual effective rate of 4 percent or the rate or rates guaranteed on issuance of the contract.

A contract will comply with the CVC Test of § 7702(d) if the death benefit under the Policy at all times is not less than a percentage set forth in § 7702(d)(2) multiplied by the contract's "cash surrender value," as defined in § 7702(f)(2)(A).

Section 7702 specifies a number of "computational rules" that must be followed in calculating NSPs under the CVAT and guideline premiums under the GPL. Specifically, NSPs and guideline premiums generally must be computed assuming that the death benefit under the contract does not increase, that the contract's maturity date is no earlier than the day on which the insured attains age 95 and no later than the day on which the insured attains age 100, that the death benefit is provided until the maturity date, and that any endowment benefit under the contract, including its cash surrender value on the deemed maturity date, does not exceed the least amount payable as a death benefit at any time under the contract. See § 7702(e)(1) and (2).

Section 7702(f)(2)(A) provides that for purposes of § 7702 "[t]he cash surrender value of any contract shall be its cash value determined without regard to any surrender charge, policy loan, or reasonable termination dividends." The Code does not elaborate on the meaning of the term "cash value" as used to define the term "cash surrender value" in § 7702(f)(2)(A). The legislative history of § 7702 includes some discussion of the terms "cash surrender value" and "cash value," stating that:

Cash surrender value is defined in the bill as the cash value of any contract (i.e., any amount to which the policyholder is entitled upon surrender and against which the policyholder can borrow) determined without regard to any surrender

charge, policy loan, or a reasonable termination dividend
[A]mounts that are returned to a policyholder of a credit life insurance policy because the policy has been terminated upon full payment of the debt will not be considered part of any cash surrender value because, generally, such amount is not subject to borrowing under the policy.

DEFRA Senate Report, at 573; DEFRA House Report, at 1444, see *also* DEFRA Bluebook, at 647.

Proposed Treasury Regulation § 1.7702-2 provides that the “cash surrender value” of a contract generally equals its “cash value.” The term “cash value,” in turn, is defined as the greater of (i) the maximum amount payable under the contract (determined without regard to any surrender charge or policy loan), or (ii) the maximum amount that the policyholder can borrow under the contract.

Section 7702(f)(7)(A) provides that if there is a change in the terms or benefits of a contract which was not reflected in any previous determination or adjustment made under § 7702, there shall be a proper adjustment in future determinations made under § 7702.

The Joint Committee on Taxation’s “Bluebook” explanation of DEFRA states:

The Act provides that proper adjustments be made for any change in the future benefits or any qualified additional benefit (or in any other terms) under the contract, which was not reflected in any previous determination made under the definitional section. Changes in the future benefits or terms of a contract can occur at the behest of the company or policyholder, or by the passage of time. However, proper adjustments may be different for a particular change, depending on which alternative test is being used or on whether the changes result in an increase or decrease in the future benefits. In the event of an increase in current or future benefits, the limitations under the cash value accumulation test must be computed treating the date of change, in effect, as a new date of issue for determining whether the changed contract continues to qualify as life insurance under the definition prescribed in the Act. Thus, if a future benefit is increased because of a scheduled change in death benefit or because of the purchase of a paid-up addition (or its equivalent), the change will require an adjustment and new computation of the net single premium definitional

limitation. Under the guideline premium limitation, an adjustment is required under similar circumstances, but the date of change for increased benefits should be treated as a new date only with respect to the changed portion of the contract. Likewise, no adjustment shall be made if the change occurs automatically, for example, a change due to the growth of the cash surrender value (whether by the crediting of excess interest or the payment of guideline premiums) or changes initiated by the company. If the contract fails to meet the recomputed limitations, a distribution of cash to the policyholder may be required.

STAFF OF THE J. COMM. ON TAX'N, 98TH CONG., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 653-54 (J. Comm. Print 1984) ("DEFRA Bluebook"). See *also* S. PRT. NO. 98-169, VOL. I, 577-578 (1984); H.R. REP. NO. 98-432, PT. 2, at 1448 (1984).

DISCUSSION

The amount available on surrender or which can be borrowed (determined without regard to surrender charges or policy loans taken) under the Policies constitutes the "cash surrender value" for purposes of § 7702(f)(2)(A). During the Rider Benefit Period, the amount that is available to be withdrawn or borrowed equals the greater of the policy value and the Annual Rider Benefit, therefore, the "cash surrender value," within the meaning of § 7702(f)(2)(A), of a Policy at any time during the Rider Benefit Period equals the greater of (i) the policy value at such time, and (ii) the Annual Rider Benefit for the Policy Year.

In addition, on the date of issue it is unknown whether and when the Rider Benefit will ever operate to increase the cash value that is available for withdrawals or loans. The factual circumstances here are not those described by the DEFRA Bluebook's discussion of a change in future benefits that require an adjustment.

Based on the facts and the representations made by Taxpayers we hold that:

1. The "cash surrender value," for purposes of § 7702(f)(2)(A), of the Policy at any time is its cash value, and a Policy's cash value is the greater of (i) the maximum amount to which the policyholder is entitled upon surrender of the Policy (determined without regard to any surrender charge or policy loan), or (ii) the maximum amount against which the policyholder can borrow under the Policy.

2. Calculations of the net single premium under the cash value accumulation test and of the guideline premium limitation for the Policy are unaffected by the presence of the Rider Benefit.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This ruling is directed only to the Taxpayers requesting it. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Temporary or final regulations pertaining to one or more of the issues addressed in this ruling have not yet been adopted. Therefore, this ruling will be modified or revoked by the adoption of temporary or final regulations to the extent the regulations are inconsistent with any conclusion in the letter ruling. See § 11.04 of Rev. Proc. 2008-1, 2008-1 I.R.B. 1, 50. However, when the criteria in § 11.06 of Rev. Proc. 2008-1, 2008-1 I.R.B. 1, 51 are satisfied, a ruling is not revoked or modified retroactively except in rare or unusual circumstances.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

The rulings contained in this letter are based upon information and representations submitted by the Taxpayers and accompanied by penalty of perjury statements executed by the appropriate parties. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

Sincerely,

Donald J. Drees, Jr.
Senior Technician Reviewer, Branch 4
(Financial Institutions & Products)

cc: